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Economics Department
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Eric B. Herr
Vice President-Economics

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U.S. BUSINESS OUTLOOK, SHORT-TERM

THE ECONOMY did its bit for the science fiction craze in 1980's second quarter by falling through a black hole in space:

- Inflation-adjusted consumption rocketed down at the near light-speed of 9.4%.
- Zapped by high mortgage rates, housing began to disintegrate. Builders ducked for cover, cutting starts by more than one-half (at an annual rate) from the already depressed first-quarter level.
- Attempting to defend balance sheets against the economic onslaught, business sharply retrenched on capital spending, slashing real investment in plant, equipment, and vehicles by 18% at an annual rate.

Altogether, the April-June period added up--or down--to a tie with the first quarter of 1975 for the worst economic quarter in the post-World War II era: Gross national product (GNP) plunged at an annual rate of 9.1%. What's more, final sales--GNP less inventory change--plummeted at a 9.6% annual rate, worse than any quarter in the severe 1973-75 downturn.

Why So Bad?

Why recession is occurring in 1980 is no big mystery. With inflation building in 1979, lenders demanded higher and higher interest rates to protect against loan repayments in cheapened dollars. (The prime rate hit an historic high of 20% in April.) Sky-high interest rates, in turn, meant that thrift institutions had to pay out more than

usual to attract funds, which in turn meant they had to raise mortgage rates. And every notch up on the mortgage rate scale meant fewer and fewer people could afford new homes. As a consequence, housing demand fell sharply; and down with it went spending on furniture and household equipment.

Meanwhile, inflation was also spurring consumers to buy at a faster and faster pace in an attempt to beat even further price hikes. And since incomes were barely keeping up with prices, people sustained their purchasing power by going heavily into debt and by reducing the amount of income saved. The saving rate dropped to 3.5% in the fourth quarter of 1979, down from 5.4% in last year's second quarter and well below the more than 7% prevailing in the first half of the 1970s; installment credit outstanding grew to more than 15% of personal income in 1979, compared to just over 13% for most of the '70s. As debts mounted, repayment plus interest costs ate an increasingly large hole in peoples' incomes. Conversely, less money was available for new purchases.

At the same time, employment was increasing only slowly in 1979, so that prospects for sizable increases in personal income were dim. Combine free spending with sluggish income growth, rising debt, and falling saving rates, and it is clear that consumers last year and into this year were engaged in a game of make-believe: They could play at pretend-prosperity for some time, but inevitably the game would end and reality would intrude.

The severity with which reality did intrude, however, was a shocker. What caused the unusually steep and unanticipated drop, apparently, was a combination of two things: On their own, consumers developed the feeling that enough was enough--any more debt-financed

spending would be intolerable. Then in addition, the Federal Reserve Board came up with its credit controls program in March. And if nothing else, these controls created enough confusion so that consumers became extra wary of using credit. Hit by the double whammy of credit over-extension and credit controls, while also fearing unemployment (employment began to fall in March), consumers went cold turkey.

Besides the consumer collapse, another surprise in 1980's second quarter was business' sharp cutback in fixed investment. Typically, it takes business a quarter or so to cut capital spending plans once the economy starts to decline, so that in the initial stage of recession business fixed investment can cushion the downturn. This time around, investment crashed immediately. Much of the decline, though, was due to reductions in truck and auto purchases. If these categories are taken out, inflation-adjusted investment fell at an 8% rather than an 18% annual rate.

Nevertheless, investment did fall, suggesting that business may be sharpening its informational antennae in order to react with increasing speed to changing economic conditions. Instant-reaction strategy was also evident in business' attempt to pare inventories by slashing production 18% at an annual rate in the second quarter. But due to steep falls in demand, inventories continued to accumulate. For the economy as a whole, inventories increased by nearly $12 billion. And that accumulation could cause trouble as firms continue their efforts to lower inventories in line with sales.

Looking Good, But...

With the economy down so deep in the second quarter, anything that happens subsequently will likely look good. However, while the economy should not suffer another plunge on the order of 9%, it is still headed downward--only at a slower pace. Moreover, the decline may well extend throughout this year. In other words, improvements in economic statistics--e.g., the index of leading indicators rose by 2.5% in June--should not obscure the fact that the economy is still worsening. But given the second-quarter shock treatment, why should any further worsening occur?

One reason, hinted at above, is inventories. The ratio of business inventories to sales climbed to 1.52 in May, up from 1.40 a year ago. Manufacturers' inventories in particular are getting out of line, implying further cutbacks in industrial production and further layoffs. Thus, even though the latest unemployment figure was "encouraging" in that it held steady at 7.8% in July, the rate is bound to rise. Moreover, even though press reports carried the news that employemnt in July rose, that rise was based on the government's survey of households, which economists consider less reliable than a parallel government survey of companies. And the company survey showed that nearly a quarter million jobs disappeared in July. This drop in employment, plus expected further drops, means that personal income in real terms will be weak, and that consumption, likewise, will be weak.

The second major reason why economic activity will continue to decline is that consumer debt loads are still too heavy and savings are still too low to allow people to surge into the stores, credit cards in hand. At the same time, consumers have been making substantial efforts to "reliquefy."

As can be seen in the table below, consumers began saving more of their disposable income in the first quarter of this year (and they are expected to continue to save more). The table also shows that people have been whittling away their debt load since late last year. In fact, in recent months the amount of installment credit outstanding has actually fallen--the first time that's happened since the spring of 1975. But for consumers to get their debt position down closer

The Consumer Seeks Liquidity

		Saving Rate (% of Disposable Income)	Installment Credit (% of Personal Income)
1979	I	5.0%	14.80%
	II	5.4	15.06
	III	4.3	15.07
	IV	3.5	15.04
1980	I	3.7	14.90
	II	4.7	14.58

to an historic norm, additional debt reduction is necessary; and as this reduction takes place, consumers will have to rein in their purchases.

Facing continued weak demand in the near term, business will find little incentive to expand capacity, thus putting a damper on fixed investment. Some "correction" of the extremely soft second quarter results may occur, however, as firms replace more of their auto and truck fleets. One spur to replacement may be a firming of used car prices, which fell in the second quarter. If fleet owners can get better deals on trade-ins, they will be more likely to buy new vehicles.

Residential investment, meanwhile, will remain weak in the third quarter--despite a resurgence of building--because the investment in housing lags behind the construction. Government spending, too, should be relatively weak. Federal government is trying to hold the line on purchases of goods and services, and state and local govenments will be constrained by recession-reduced tax revenues.

In sum, while the economy went through a wringer in the second quarter of 1980, there is more wringing to come. The recession will extend, at least, through the third quarter; and at best, the fourth quarter could show feeble growth. By the first quarter of next year, however, recovery should be underway.

Looking Good, No Buts

The initial stage of recovery will be driven by house building. From April to June, mortgage reates dropped by three percentage points to about 13.5% on average. That may still seem high, but it lead to a surge of house buying in May (sales were up 39% over April) and then to an unexpectedly robust snapback in June housing starts (up 30% over May). Meanwhile, the madian price of a house in the U.S. declined from $64,800 in February to $62,600 in May. At the same time, federally-insured savings and loan associations increased their mortgage commitments in June by 1.5 billion.

All in all, then, everything is in place for a housing comeback. After having fallen from an annual rate of 1.8 million in last year's second quarter to just over a million in 1980's second quarter, housing starts are seen climbing back to more than 1.2 million in the third quarter. By the fourth quarter of 1981, starts are expected to be running at an annual rate of 1.7 million.

Following on the heels of housing in chasing economic activity upward will be purchases of consumer durables. As more houses are bought, it follows that more furniture and appliances will be bought. But in addition, people are expected to buy more autos--even ones made in America.

For U.S. carmakers, the second quarter of 1980 was worse than anything they suffered in the 1973-75 recession; consumers bought only 5.5 million domestically made cars (annual rate), down a third from 1979 sales levels. But even though American cars may have permanently lost a substantial share of market to foreigners, Detroit's OPEC-engineered depression can't last forever. Fueling the pickup in car sales will be improved consumer liquidity, relatively attractive interest rates on car loans, the need to replace cars that should have been traded in months ago, and U.S. manufacturers' introduction of new fuel-efficient models. Some rebound, in fact, has already occurred; in July, sales jumped up to a 6.4 million unit annual rate. By the second quarter of 1981, sales are expected to exceed 7 million units.

Once housing and autos turn around, the recovery will gain momentum. These two key sectors will give employment a boost, in turn leading to a rise in personal income and then to increases in consumer spending. A general rise in economic activity will stimulate increases in business fixed investment, and will also lead to increased revenues and spending by state and local governments.

The second and third quarters of 1981 are thus forecast to show solid growth of 4.6% and 4.8%, respectively. Overall, 1981 is expected to register growth of 0.8%, following a 1980 decline of 1.5%.

Risks to the Outlook

The only major sector whose role in recovery was not mentioned was the federal government. As for federal sending on goods and services, it seems clear that no matter who is President, spending will be kept fairly tight--that is, will not serve as the engine of recovery.

But what is not clear is government tax policy: Will there be a tax cut? If so, when? what kind? how much?

Given the political uncertainties surrounding such questions, a good assumption at this point seems to be that a tax cut will occur, under any President, but that at most it will be neutral--it will at most offset increases in Social Security taxes scheduled for next year and increases in taxes due to "bracket creep." In the short run, the net effect of such a tax cut on consumer demand would be small; and uncertainty about the form of the tax cut could delay investment decisions by business.

Another short-run effect would be a bigger federal deficit, and therefore a bigger borrowing requirement that will put upward pressure on interest rates. Which leads to the final federal question: What policy will the Federal Reserve Board follow?

Last October, the Fed let it be known that from then on it would be exercising tighter control over money growth. And even though interest rates subsequently skyrocketed, the Fed stuck to its guns. Moreover, the Fed chairman recently announced that money growth targets were being lowered. Given this evidence, plus numerous Fed statements promising not to backpedal on its October policy, it seems probable that when the

recovery spurs increased credit demands, interest rates will ascend to uncomfortable levels, partly choking off housing and auto demand.

Longer term, however, relatively tight Fed policy will cool the inflationary fires so that, perhaps by late 1981, the inflation premium on interest rates will have declined enough for rate increases to moderate.

In sum, the scenario foreseen here is that the recovery will be only modest due to rising interest rates and limited credit availability. Thus, even by 1981's fourth quarter real GNP is expected to be lower than in 1980's first quarter. The bright side of this scenario is that if the Fed maintains its policy, inflation will abate, setting the stage for solid growth in 1982.

If, by contrast, the Fed accommodates increased borrowing demands in the recovery, keeping interest rates down and demand up, it would kick off an inflationary spiral early in the recovery. Consumers, once more, would rush to buy, and in the process again get over their heads in debt. At the same time, inflation premiums would be getting built into interest rates, again putting strains on consumer liquidity. In short, economic volatility would persist, further feeding business and consumer uncertainty, thus further causing business and consumers to focus narrowly on short-term--at the expense of long-term--considerations.

Risks to the forecast presented at the end of this report, then, are: On the upside, the recovery could be stronger if the Fed yields to pressure to ease monetary policy. On the downside, inflation could be significantly worse than forecast by mid-1981. If inflation does take

off, housing could get hit by the end of next year as mortgage rates zoom; and business investment could be weaker as firms allocate funds to short-term profit maximization tactics in the face of an increasingly uncertain future.

Summary

Though the economy hurtled downward last quarter at a startling rate, the crash landing has yet to come. The recession, that is, still has some way to go, even though the economic news from now on will probably sound good in contrast to the news generated by the April-June period. More specifically, GNP in the third quarter is expected to decline at a 5.1% annual rate compared to the 9.1% debacle of the second quarter. By the fourth quarter of the year, the rate of economic decline is forecast to slow further to 0.5%.

Meanwhile, even as the economy continues to slide, increased house building will be spurring employment and income; and increased house buying (due to the fall in mortgage rates) will be spurring increased purchases of furniture and appliances. Following housing, the auto industry is expected to get a lift as consumers--who in recent months have been reducing debt loads--once again feel ready to buy on credit. And since they have not been much in the car market for a long time, they will want to replace the cars that should have been traded in last year.

Recovery, then, should be underway within six months. But even though 1981 is seen as a year of positive economic growth, the advance should be modest. Relatively tight monetary policy will likely lead early in the recovery to high interest rates, which in turn will shut off some demand for housing and autos. At the same time, federal

spending will not be doing a lot to fire up demand; and while a tax cut is expected, it does not now appear that it will be large enough to offset increases in taxes due to take effect in 1981.

The cheery side of the non-expansionary fiscal and monetary policies is that the inflation rate should moderate, thereby putting downward pressure on interest rates by late next year. Importantly, an improved inflation outlook would also help create the kind of stable environment needed for solid long-term economic growth.

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NATIONAL PRODUCT ACCOUNTS AND KEY ECONOMIC INDICATORS
(Billions of Dollars)

	Actual	Forecast						Annual		
	1980	1980		1981						
National Product Accounts	2Q	3Q	4Q	1Q	2Q	3Q	4Q	1979	1980	1981
Gross National Product	2523.4	2545	2596	2664	2751	2845	2937	2368.8	2546.3	2799.3
Consumer Spending	1628.2	1654	1687	1730	1789	1845	1889	1509.8	1649.7	1813.3
Gross Private Domestic Investment	366.9	353	362	375	393	415	445	387.2	367.4	407.0
Fixed Investment	355.2	352	360	371	386	400	420	369.0	362.6	394.3
Nonresidential	265.9	264	268	270	273	277	288	254.9	267.6	277.0
Residential	89.3	88	92	101	113	123	132	114.1	94.9	117.3
Inventory Change	11.7	1	2	4	7	15	25	18.2	4.9	12.8
Government Purchases	527.0	538	552	566	580	597	616	476.4	533.6	589.8
Federal	192.5	198	206	214	221	227	236	166.6	195.7	224.5
State & Local	334.5	340	346	352	359	370	380	309.8	337.9	365.3
Net Exports	1.3	0	-5	-7	-11	-12	-13	-4.6	-4.3	-10.8
Real GNP (1972 dollars)	1410.8	1392.6	1390.8	1396.8	1412.7	1429.2	1443.0	1431.6	1409.7	1420.4
(% change at annual rate)	-9.1	-5.1	-0.5	1.7	4.6	4.8	3.9	2.3	-1.5	0.8
Implicit Price Deflator (% change at annual rate)	10.4	9.0	8.8	8.7	9.0	9.2	9.3	8.8	9.2	9.0
Key Economic Indicators										
Unemployment Rate (percent)	7.5	8.5	8.9	9.0	8.7	8.2	7.9	5.8	7.8	8.5
Housing Starts (thousands of units)	1045	1225	1325	1450	1550	1625	1700	1745	1215	1581
Consumer Price Index (% change at annual rate)	13.6	10.2	8.9	9.2	10.0	10.1	10.1	11.2	13.7	9.9